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Financial meltdown: How it all happened

As Arizona state treasurer, my office manages a $12 billion portfolio and last year distributed profits of over $500 million to state and local governments.

Last week, I watched in horror as the U.S. government's schizophrenic actions created this financial meltdown. Now, they want nearly a trillion taxpayer dollars to fix it.

Action is needed immediately, but taxpayers should not pay for others' mistakes. The last thing we need is FEMA running our local bank.

Our financial system is in a logjam, gripped by fear. The proposal to buy all the logs to remove the jam is expensive and rewards those who took large risks as much as those who did not. Instead, treat the disease directly, make the system more transparent and separate the good loans from the bad, saving taxpayers hard-earned cash.

Main Street home buyers, Wall Street investors and the federal government are sitting on piles of debt. Easy money led to low lending standards, fueling housing speculation in Arizona and elsewhere. Because money was easy to get, lenders lowered standards to attract more borrowers. These debts were then bundled together and sold on Wall Street to institutional investors to raise capital to make more loans.

The problem was a lack of transparency; bundling loans obscured the risks from investors. Prime loans were bundled together with jumbos, subprime loans and others while still receiving "A" ratings. Many investors just assumed the "A" rating meant all mortgages inside were safe.

In August of last year, Wall Street realized that it owned subprime loans in portfolios that did not plan for that risk. At that point, the market froze. The housing bubble had burst and subprime loans were now seen as contaminated; anything they touched was considered toxic risk that no one wanted to buy.

The lack of transparency in bundled mortgages made it difficult to know how many subprime loans were inside. Therefore, all mortgage securities were treated as toxic. Investors avoided all mortgages to prevent accidentally buying subprime.

It's like the adage: "One bad apple spoils the barrel." So it was with subprime spoiling the entire mortgage market.

New accounting rules designed for liquid markets now began to put the squeeze on banks even though more than 90 percent of Americans are still paying their mortgages.

After the fraud at Enron, Congress changed the accounting rules to "mark to market." Assets had to be priced according to what the market said they were worth if you liquidated them today. This was a very good rule for preventing unscrupulous individuals from overinflating their balance sheets. However, it works only when a functioning and liquid market exists to price the assets.

When mortgage markets froze last August, demand evaporated for the now-toxic mortgage bundles. This crushed many banks' balance sheets as they had to list mortgages at pennies on the dollar. Instead of having these assets on the books as collateral to make more loans, banks now needed to borrow money to stay afloat. Banks, however, stopped lending to other banks due to fear of getting indirect exposure to subprime loans. Banks depend on short-term cash to stay afloat. A total credit freeze puts our financial system in peril.

Since the Great Depression, the Federal Reserve has been the lender of last resort to banks. During a crisis, if short-term cash ran dry, they could borrow from the Fed in order to prevent a run on the bank. When Bear Stearns faced a liquidity crisis, the Fed provided backstop lending to JPMorgan to assume Bear's assets and liabilities. It promised the same assurances to other investment banks in this liquidity crisis.

This contained the problem for a while. Confidence was shaken, but given the commitment to help banks get through any short-term liquidity crisis, the market was likely to avoid catastrophic failure.

Then, the government caused the catastrophic failure it was trying to prevent.

Despite nearly a year of promises, after the markets closed, the government reversed its position. It would not provide the same backstop as Bear Stearns to Lehman Brothers, an investment bank with positive net assets of $26 billion. It forced a company that was "A" rated on a Friday to file bankruptcy the following Sunday.

Panic gripped the financial markets. The forced bankruptcy of Lehman destroyed insurance company AIG's balance sheet. As fear ravaged investment portfolios, the government reversed itself again. It seized control of AIG, nationalizing it and pouring in $85 billion. By week's end, the government had spent more money trying to contain the firestorm it unleashed by reneging on Lehman than it would have cost to support its sale.

Worldwide, investors (and taxpayers) were losing confidence in U.S. government economic leaders. The government is supposed to be the referee, calling a fair game, not choosing winners and losers.

The original strategy of providing only emergency lending during a liquidity crisis made sense. Nationalizing financial institutions does not. When your neighbor's house is on fire, you lend him a hose; you don't have him sign over the deed to the house before you help put out the fire.

Congress needs to take action to fix this problem immediately; the longer it waits, the more damage is done. But it needs to treat the disease. Allow the mortgage bundles to be broken up, separate the toxic subprime loans that are causing the logjam from all other loans. Provide insurance for all other mortgages. This way, the 90 percent of Americans who are still paying their mortgages are rewarded for doing so, and the fear that has gripped the markets about the housing bubble will subside.

Allow banks to value the now-insured loans based upon how many are still paying their mortgages, rather than liquidation value. This will unfreeze credit and get our economy moving again (and it's a lot cheaper than just buying everything).

I would rather bet on the majority of Americans who pay their mortgages, rather than bail out those who made risky investments.

Dean Martin, a Republican, is Arizona's Treasurer